IN THE COURT OF APPEALS OF TENNESSEE
AT NASHVILLE
May 4, 2005 Session

COY ALLEN KIDD ET AL. v. JARVIS DRILLING, INC. ET AL.

Appeal from the Chancery Court for Davidson County
No. 03-90-II Carol McCoy, Chancellor

No. M2004-00973-COA-R3-CV - Filed February 14, 2006

This appeal arises from a dispute between an oil drilling company and a group of Scott County property owners regarding the company's plans to recover oil from the currently non-producing West Oneida Field. After the Tennessee Oil and Gas Board approved the company's unitization and secondary recovery plans, the property owners filed a petition in the Chancery Court for Davidson County seeking judicial review of the Board's decision. The trial court affirmed the Board's decision, and the property owners appealed. We have determined that the record supports the Board's approval of the unitization plan and the secondary recovery plans. However, we have also determined that the Board failed to make all the findings required for the approval of the subterranean gas storage portion of the plan. Accordingly, we vacate the trial court's order approving the plan and remand the case with directions that it be remanded to the Board for further proceedings.

Tenn. R. App. P. 3 Appeal as of Right; Judgment of the Chancery Court Vacated

WILLIAM C. KOCH, JR., P.J., M.S., delivered the opinion of the court, in which PATRICIA J. COTTRELL and FRANK G. CLEMENT, JR., JJ., joined.

Phillips M. Smalling, Byrdstown, Tennessee, for the appellants, Coy Allen Kidd et al.

James Frank Wilson, Wartburg, Tennessee, for the appellee, Jarvis Drilling, Inc.

Paul G. Summers, Attorney General and Reporter; Michael E. Moore, Solicitor General; and Elizabeth P. McCarter, Senior Counsel, for the appellee, Tennessee Oil and Gas Board.

OPINION

I.

The West Oneida Field, located on the Fort Payne reservoir in Northeast Tennessee, was discovered in 1943. The first oil well was drilled in September 1969, and in 1979, the peak oil rate reached 1,720 barrels per day. By 1974, there were 51 producing oil wells and 13 natural gas wells

on the field.[1] By 1997, the number of oil wells had increased to 62, and the number of natural gas wells to 15.[2] A majority of the producing wells were operated by Jarvis Drilling, Inc. (Jarvis Drilling), a Kentucky corporation that had possessed an ownership interest in the field since 1977.

By December 1996, the West Oneida Field had produced 1,452,355 barrels of oil or 12.9% of the estimated amount of oil originally in the field. However, production had fallen off significantly because of the release over the years of the natural gas that had provided the energy needed to extract the oil.[3] Jarvis Drilling retained experts to assess the amount of oil remaining in the field and to recommend economically feasible alternatives for extracting the remaining oil. In December 1997, these experts reported that another 1,493,000 barrels of oil could be recovered from the West Oneida Field over twenty years using an enhanced secondary recovery process. The process recommended by the experts entailed injecting natural gas back into the field to increase the pressure in the reservoir. The experts anticipated that the re-pressurization of the field would drive the remaining oil to the downdip oil wells.[4]

Accordingly, Jarvis Drilling set about to devise a financially viable secondary recovery plan to extract more oil from the West Oneida Field. Its plan had two key components. The first component was the unitization of the West Oneida Field.[5] The second component was the use of the field to store natural gas owned by others for a fee. This natural gas, referred to as "working gas," would aid in the re-pressurization of the field and would be an additional source of income that would make the secondary recovery plan financially viable.[6]

In April 2001, Jarvis Drilling filed a petition with the Tennessee Oil and Gas Board (Board) seeking the unitization of the West Oneida Field in accordance with Tenn. Comp. R. & Regs. 1040-5-1-.01 (1999). Jarvis Drilling also sought the Board's approval of its "pressure maintenance and secondary recovery project" under Tenn. Comp. R. & Regs. 1040-4-9-.03 (1999). In January 2002, Jarvis Drilling's expert forwarded a completed copy of the Board's "Pressure Maintenance and

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[1] Another 20 dry holes had been drilled by 1974.

[2] There were also 32 dry or plugged and abandoned wells in 1997.

[3] By December 1996, the production of oil had dropped to 7 barrels per day. While the original reservoir pressure had been 770 psi, the pressure in December 1996 was only 25-50 psi .

[4] In a hydrocarbon reservoir that contains oil, natural gas, and water, the gas is "updip," the gas-oil contact is "downdip" from the gas, and the oil is still further "downdip." When the bottom of a hydrocarbon reservoir is sloping rather than flat, a "downdip" well is located down the slope.

[5] Unitization is an industry term for operating multiple tracts of land as a single tract for the purpose of producing oil or gas. Tenn. Comp. R. & Regs. 1040-1-1-.01 (1999) defines a "pooled unit" as "two or more tracts of land, of which their ownership may be different, that are consolidated and operated as a single tract for production of oil and/or gas, either by voluntary agreement between the owners thereof, or by exercising of the authority of the Board under the statute."

[6] Jarvis Drilling's expert estimated that the income from gas storage over twenty years would be $54,400,000 and that the net profit from the secondary recovery plan would be $44,457,785. Accordingly, the plan would not be financially viable without the income derived from storing natural gas for others.

Secondary Recovery Questionnaire" requesting approval of its plans for "field unitization" and "gas storage."

The Board notified all affected persons of Jarvis Drilling's petition and of a contested case hearing set for June 10, 2002. This hearing was held in Nashville and was attended by representatives of Jarvis Drilling and several property owners and their lawyer who objected to the unitization plan. Jarvis Drilling presented a great deal of evidence regarding the technical details of its secondary recovery plan. It also presented evidence that 95.45% of the persons affected by its proposal had approved its secondary recovery project. The dissenting property owners, in turn, voiced their objections to unitization and gas storage. These objections were based on the property owners' belief that the proposed unitization plan did not compensate them adequately for their interests and that the plan, if implemented, would prevent them from obtaining natural gas from the field for personal use.[7] On November 12, 2002, the Board filed a final order approving the unitization plan as well as the pressure maintenance and secondary recovery project.

On January 8, 2003, forty-three persons whose interests would be affected by the Board's order filed a petition for review in the Chancery Court for Davidson County. They asserted that the record did not contain substantial and material evidence to support the Board's approval of Jarvis Drilling's unitization plan because (1) the plan was not "economically feasible for oil and gas production alone," (2) it did not "fairly protect the correlative rights of the landowners," and (3) it failed to adequately compensate them. They also asserted that the Board did not have the authority "to force the use of a unitized pool for gas storage" because all affected parties had not consented to the gas storage plan. The trial court filed a memorandum opinion on March 18, 2004 approving the Board's November 12, 2002 order. The property owners have appealed.

II.

The Board, like every other administrative agency, has no inherent power. Its authority comes from the General Assembly, and thus its power is limited to the power that is expressly granted by statute or that must be necessarily implied to enable it to carry out its statutory responsibilities. *See Sanifill of Tenn., Inc. v. Tennessee Solid Waste Disposal Control Bd.*, 907 S.W.2d 807, 810 (Tenn. 1995); *Methodist Healthcare-Jackson Hosp. v. Jackson-Madison County Gen. Hosp. Dist.*, 129 S.W.3d 57, 69 (Tenn. Ct. App. 2003); *BellSouth Telecomms., Inc. v. Greer*, 972 S.W.2d 663, 680 (Tenn. Ct. App. 1997). The enabling statutes specifically empower the Board to make rules, regulations, and orders to regulate secondary recovery methods,[8] to provide for the forced integration of separately owned tracts and other property ownership into drilling and

[7] One property owner testified that four natural gas wells were located on her property and that she was obtaining natural gas from these wells for her private use, even though she was also connected to a private gas utility. Jarvis Drilling's witness explained that these wells would be capped for safety purposes because of the increased pressure in the field once re-pressurization began.

[8] Tenn. Code Ann. § 60-1-202(a)(4)(K) (2002).

production units,[9] and, in certain circumstances, to force a volumetric or surface poolwide unit.[10] Tenn. Code Ann. § 60-1-204 (2002) also grants the Board broad rule-making authority.

The Board has promulgated separate rules regarding secondary recovery projects, unitization, and subterranean storage of natural gas. These projects may be approved administratively by the State Oil and Gas Supervisor as long as all operations lie within a single lease or all interested parties voluntarily agree. Tenn. Comp. R. & Regs. 1040-4-9-.02. However, in the absence of a unanimous agreement, operations occurring on more than one lease must be approved by the Board following a public hearing, Tenn. Comp. R. & Regs. 1040-4-9-.03, and the field must be unitized before the Board approves the secondary recovery project. Tenn. Comp. R. & Regs. 1040-4-9-.04.

The Board has promulgated rules defining the conditions that must be met before it will exercise its power under Tenn. Code Ann. § 60-1-202(a)(4)(M) to force unitization of a field. Unitization may be required only after the Board has determined that unitization (1) is necessary to conserve the State's natural resources,[11] (2) will prevent waste[12] of oil and gas and the drilling of unnecessary wells, (3) will appreciably increase the ultimate recovery of oil and gas from the affected pool, (4) is economically feasible, and (5) will protect the correlative rights of both landowners and owners of mineral rights. Tenn. Comp. R. & Regs. 1040-5-1-.01(1)(a) (1999). The Board must also see to it that the proposed unitization plan assures that the owners of the separate tracts receive their just and equitable share of the recoverable oil or gas in the unit, Tenn. Comp. R. & Regs. 1040-5-1-.01(1)(b), and that the cost of production is proportionately allocated among the separately owned tracts. Tenn. Comp. R. & Regs. 0140-5-1-.01(1)(d).

Projects involving subterranean natural gas storage must be approved by the Board following a public hearing. Tenn. Comp. R. & Regs. 1040-4-8-.01 (1999). The rules regarding subterranean natural gas storage differentiate between reservoirs "capable of producing oil and gas in paying quantities" and reservoirs that cannot. With regard to reservoirs that are capable of producing oil and gas in paying quantities, the rule provides that the Board may not approve a subterranean gas storage project unless "all owners in such underground reservoir shall have agreed thereto in writing." Tenn. Comp. R. & Regs. 1040-4-8-.01(1), -01(2). Before the Board approves a subterranean natural gas storage project, it must also find (1) that the underground reservoir sought to be used is suitable and feasible for such use,[13] (2) that the use of the underground reservoir to store natural gas will not contaminate other formations containing fresh water, oil, gas, or other

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[9] Tenn. Code Ann. § 60-1-202(a)(4)(M).

[10] Tenn. Code Ann. § 60-1-202(a)(4)(N).

[11] Tenn. Comp. R. & Regs. 1040-1-1-.01 defines "conservation" as "conserving, preserving, guarding, or protecting the oil and gas resources of the State by obtaining the maximum efficiency with minimum waste in the production, transportation, processing, refining, treating, and marketing of the unrenewable oil and gas resources of the State."

[12] For the purpose of this provision, "waste" is a term of art and is defined in Tenn. Code Ann. § 60-1-101 (13) (2002).

[13] Tenn. Comp. R. & Regs. 1040-4-8-.01(1).

commercial mineral deposits,[14] (3) that the proposed storage will not endanger lives or property,[15] and (4) that the storage reservoir may be drilled through for the purpose of exploration for, or producing of, "underlying oil and/or gas pools."[16]

III.

The property owners insist that the Board lacks authority to force unitization for the purpose of subterranean natural gas storage for two reasons. First, they argue that the Board's enabling statutes do not expressly empower the Board to require unit operations for subterranean natural gas storage. Second, they assert that, even if the Board has the authority to approve unit operations for natural gas storage, its regulations do not permit subterranean gas storage without the unanimous written approval of all owners in interest. The property owners are mistaken on both counts.

A.

Administrative agencies have the prerogative to interpret their enabling statutes and their own rules and regulations. While the courts will give careful consideration to their interpretation of statutes, especially when their interpretation sheds light on legislative intent, *State ex rel. Pope v. U.S. Fire Ins. Co.*, 145 S.W.3d 529, 536 (Tenn. 2004), statutory construction remains a question of law. Accordingly, the courts review an agency's interpretation of statutes without a presumption of correctness. *Patterson v. State Dep't of Labor & Workforce Dev.*, 60 S.W.3d 60, 62 (Tenn. 2001); *Jones v. Bureau of Tenncare*, 94 S.W.3d 495, 501 (Tenn. Ct. App. 2002).

The construction of administrative rules and regulations is likewise a question of law. *Cape Fear Paging Co. v. Huddleston*, 937 S.W.2d 787, 788 (Tenn. 1996); *Beare Co. v. Tenn. Dep't of Revenue*, 858 S.W.2d 906, 907 (Tenn. 1993). The courts will give great weight to an agency's interpretation of its own rules, *Exxon Corp. v. Metro. Gov't*, 72 S.W.3d 638, 641 (Tenn. 2002), especially an interpretation that has been consistently followed for many years without challenge, *SunTrust Bank v. Johnson*, 46 S.W.3d 216, 226 (Tenn. Ct. App. 2000). However, the courts will decline to adopt an agency's interpretation of a rule if the interpretation (1) is plainly erroneous, (2) is inconsistent with the plain language of the rule, or (3) has no reasonable basis in law. *Jackson Express, Inc. v. State Pub. Serv. Comm'n*, 679 S.W.2d 942, 945 (Tenn. 1984); *Cawthron v. Scott*, 217 Tenn. 668, 674, 400 S.W.2d 240, 242 (1966); *Envt'l Defense Fund, Inc. v. Tenn. Water Quality Control Bd.*, 660 S.W.2d 776, 781 (Tenn. Ct. App. 1983).

B.

The Board has unquestioned statutory authority to approve and regulate secondary recovery projects. Tenn. Code Ann. § 60-1-202(a)(4)(K). While neither the statutes nor the Board's rules define "secondary recovery project," the term is commonly used in the industry to refer to the

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[14] Tenn. Comp. R. & Regs. 1040-4-8-.01(3).

[15] Tenn. Comp. R. & Regs. 1040-4-8-.01(4).

[16] Tenn. Comp. R. & Regs. 1040-4-8-.01(5).

enhanced methods used to recover additional oil or to prolong the production of oil in fields where the primary production has run its course. The purpose of a secondary recovery project is to restore the pressure in the reservoir by mechanisms such as gas reinjection.[17]

One of the Board's obligations is to prevent the waste[18] of Tennessee's non-renewable oil and natural gas resources. Secondary recovery projects prevent waste by prolonging the economic life of older oil fields and by increasing the quantity of oil ultimately recovered from the reservoir. In a similar manner, unit operations also prevent waste by increasing the amount of oil produced in a particular field.

The Board's rules explicitly envision that field unitization may be a part of a secondary recovery project. Tenn. Comp. R. & Regs. 1040-4-9-.04 states that a unitization plan must be approved before approving a secondary recovery project when the common source of supply is not limited to a single lease. Thus, the Board's statutes and rules clearly permit the Board to impose unitization on an oil field for the purpose of operating a secondary recovery project.

The property owners assert that even if the Board has the power to approve forced unitization as part of the secondary recovery project, it does not have the power to permit the unit operator to engage in the subterranean gas storage business as part of the operation of a secondary recovery project. The enabling statutes and the rules do not support this argument.

Restoring the pressure in an oil field is accomplished by injecting natural gas back into the field. The unit operator may obtain the required natural gas in one of two ways. It may purchase the natural gas, or it may charge others to store their natural gas in the oil field. The net effect is the same whether the operator buys the natural gas or charges others to store the gas – the field is re-pressurized, and additional oil that would not otherwise be recovered is produced. Accordingly, the Board's broad statutory authority to regulate secondary recovery projects includes the authority to authorize subterranean gas storage as part of a secondary recovery project.

C.

Using a reservoir for subterranean gas storage may be part of a secondary recovery project. However, if the operator of a secondary recovery project intends to include subterranean gas storage as part of the secondary recovery project, then the operator must also comply with the Board's requirements for subterranean gas storage. The property owners insist that Jarvis Drilling cannot comply with these requirements because all the affected owners have not consented to the subterranean storage of natural gas in the West Oneida Field.

The property owners have misconstrued Tenn. Comp. R. & Regs. 1040-4-8-.01(1). This rule requires unanimous written agreement by all the owners of the underground reservoir only when the

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[17] A pressure maintenance program may be part of a secondary recovery program, even though it may also begin during the primary recovery stage.

[18] Tenn. Code Ann. § 60-1-101(13) and Tenn. Comp. R. & Regs. 1040-1-1-.01 define "waste" in the context of oil and gas production.

reservoir involved is "capable of producing oil and gas in paying quantities." The evidence before the Board demonstrates convincingly that the West Oneida Field is no longer capable of producing oil and gas in paying quantities. Therefore, Jarvis Drilling was not required to obtain the written consent of all owners before obtaining the Board's approval to use the West Oneida Field for subterranean gas storage.

Jarvis Drilling explicitly requested the Board's approval for "gas storage" in its January 2002 "Pressure Maintenance and Secondary Recovery Questionnaire." However, the Board, without explanation, never addressed whether Jarvis Drilling's proposal met all the requirements for subterranean gas storage in Tenn. Comp. R. & Regs. 1040-4-8-.01. Even though the absence of written consent by all owners is not an impediment to approving the project, Tenn. Comp. R. & Regs. 1040-4-8-.01(3), (4), and (5) require the Board to satisfy itself that storing natural gas in the West Oneida Field will not contaminate other formations containing fresh water, oil, gas, or other commercial mineral deposits or endanger lives or property and that the plan will permit drilling to explore for or produce oil or gas from underlying pools.

The Board's failure to address the issues in Tenn. Comp. R. & Regs. 1040-4-8-.01(3), (4), and (5) undermines the validity of its November 12, 2002 order. Accordingly, even though the trial court overlooked the Board's omission, we are left with little choice other than to vacate the trial court's March 18, 2004 order approving the Board's action and to direct the trial court to vacate the Board's order and remand the proceeding to the Board for further consideration of Jarvis Drilling's proposal in light of the requirements in Tenn. Comp. R. & Regs. 1040-4-8-.01.

IV.

As a final matter, the property owners assert that the Board erred by approving Jarvis Drilling's unitization plan for the West Oneida Field because (1) the proposed unitization plan is not economically feasible, (2) the proposed unitization agreement is not fair and equitable, and (3) the dissenting property owners cannot be charged for the cost of gas storage. We have determined that each of these arguments are misplaced.

Unitization plans must be economically feasible. Tenn. Comp. R. & Regs. 1040-5-1-.01(1)(a). The property owners, separating the proposed unitization plan from its gas storage component, insist that unitization of the West Oneida Field is not economically feasible because it would not be profitable without gas storage income. While the property owners are correct that the gas storage income is necessary to the economic feasibility of the project, they are incorrect when they argue that the secondary recovery project and the gas storage proposal should be considered separately. Subterranean gas storage is an integral part of the secondary recovery project because it is one of the ways that Jarvis Drilling plans to re-pressurize the West Oneida Field. Secondary recovery will not be possible without re-pressurization, and re-pressurization will necessitate injecting natural gas into the reservoir. Insofar as re-pressurization is concerned, it matters not how Jarvis Drilling obtains the natural gas. Accordingly, the Board acted properly when it considered the economic feasibility of Jarvis Drilling's unitization plan in light of the revenue Jarvis Drilling anticipated from natural gas storage.

Unitization plans must protect the correlative rights of the affected parties and must be just and equitable. Tenn. Comp. R. & Regs. 1040-5-1-.01(1)(a), (b). The property owners take issue with eight provisions in Jarvis Drilling's proposed unitization agreement and insist that the Board erred by approving the proposed agreement without separately considering the fairness of each provision in the agreement. We find no authority for requiring the Board to review each provision in a proposed unitization agreement, and, therefore, we decline to find that the Board erred by considering the entire agreement in light of the parties' testimony regarding its fairness.

An overwhelming number of affected property owners must have found the terms of the proposed unitization agreement to be just and equitable because they consented to it. In light of the overwhelming acceptance of the agreement, the dissenting property owners faced an uphill struggle to demonstrate to the Board how the proposed agreement was not just and equitable. Their evidence focused on their skepticism that they would receive any of the revenue from the secondary recovery project,[19] their belief that they might have received more if Jarvis Drilling were required to negotiate with them individually, and their concern that they would no longer be permitted to use natural gas from the West Oneida Field for their personal use. The record reflects that the Board factored these concerns into its deliberations and then determined, based on its expertise, that the proposed unitization agreement was consistent with industry standards and that it was just and equitable. We will not second-guess the Board.

Finally, the dissenting property owners insist that the Board erred by approving a provision requiring that part of the costs of the natural gas storage portion of the secondary recovery project be deducted from their proceeds. They insist that the Board does not have the authority to require them to share in the costs of a subterranean gas storage program. We disagree because the gas storage program is an integral part of the secondary recovery project. The Board's rules expressly require affected property owners to pay their pro-rata share of the costs of the secondary recovery project.

Unit operations and secondary recovery projects are intended to benefit all affected owners by increasing the amount of oil recovered from a field. The Board's rules reflect a policy that owners who benefit from these projects must pay their fair share of the expenses reasonably incurred to extract the oil. These rules are intended to dissuade dissenting property owners from becoming "free riders."[20] They require property owners either to pay their pro-rata share of the costs of the project or to have between 150% and 350%[21] of these costs deducted from their share of the proceeds. Tenn. Comp. R. & Regs. 1040-4-9-.07, 1040-5-1-.01(d).

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[19]One dissenting property owner was projected to receive $48,000 over the 20-year life of the secondary recovery project. Her reaction to this projection was "[s]eeing is believing." She later testified, "Could I get all of this in writing, please, a guarantee?"

[20]In the parlance of economics, a "free rider" is a person who chooses to receive the benefits of a good or service without paying for it. Free riders are persons who take more than their fair share of benefits or who do not shoulder their fair share of the costs of their use of a resource.

[21]The amount of the deduction depends upon whether the activity is a pressure maintenance or secondary recovery project or a primary recovery project. The deduction is higher with regard to unit operations of a primary recovery project.

The fact that Jarvis Drilling's proposal for the West Oneida Field contains a subterranean gas storage component does not transform the project into anything other than a secondary recovery project. Accordingly, Tenn. Comp. R. & Regs. 1040-4-9-.07 applies, and the Board, in its discretion, had the power to set the surcharge on dissenting property owners who declined to pay their pro-rata share of the costs of the secondary recovery project anywhere between 150% and 200% of their share of the actual costs. Based on the evidence, the Board determined that the surcharge to dissenting owners who did not contribute their pro-rata share of the production costs would be 200%. The record provides no legal or factual basis to disagree with this decision.

V.

In summary, we find that the Board has authority to approve the use of subterranean gas storage as an integral part of Jarvis Drilling's proposed secondary recovery project and to impose unitization on the West Oneida Field as part of this project. We also find that the record supports the Board's conclusion that Jarvis Drilling's project is economically feasible, that the proposed unitization agreement is fair and equitable, and that the dissenting property owners who decline to pay their pro-rata share of the costs to extract the oil, including the costs associated with subterranean gas storage, should be required to pay a surcharge amounting to 200% of their pro-rata share of the costs.

However, subterranean gas storage is an integral part of Jarvis Drilling's secondary recovery project for the West Oneida Field. Accordingly, Jarvis Drilling was required to demonstrate that its proposed project complies with Tenn. Comp. R. & Regs. 1040-4-8-.01. The Board did not focus on these issues during its hearing and failed to make findings of fact with regard to the project's compliance with Tenn. Comp. R. & Regs. 1040-4-8-.01(3), (4), and (5). Accordingly, the Board's order approving the project must be vacated and the matter must be remanded to enable the Board to address Jarvis Drilling's compliance with Tenn. Comp. R. & Regs. 1040-4-8-.01.

The case is remanded to the trial court with directions to enter an order vacating the Board's November 12, 2002 order and remanding the case to the Board with directions to consider and make findings of fact regarding the project's compliance with Tenn. Comp. R. & Regs. 1040-4-8-.01. The costs of this appeal are taxed in equal proportions to the State of Tennessee and to Jarvis Drilling, Inc. for which execution, if necessary, may issue.

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WILLIAM C. KOCH, JR., P.J., M.S.